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## **SEC BEGINS COMPREHENSIVE REVIEW OF MARKET STRUCTURE ISSUES**

**U.S. Senator Ted Kaufman**

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Mr. President, Wall Street has undergone a radical transformation in recent years. We saw the rise of high frequency trading, where buy and sell orders move in milliseconds. We saw the emergence of so-called dark pools, which permit confidential trading in growing volumes to take place away from the public eye. We now have some trading firms' computer servers enjoying the advantage of onsite location at an exchange, a practice known as co-location. We have seen the creation of flash orders, which allow certain traders to see orders before anyone else. There have been new developments in payments for order flow, a practice that permits market centers to pay a broker to route a trade its way.

These and myriad other practices, almost too complicated to describe, have fundamentally changed the way our markets operate. We now have a high-tech, profit-driven arms race -- which continues to escalate every day -- that has transformed the ways and the places and the speeds in which stocks and other securities are traded.

There are at least two questions that now must be posed, questions that we must look to the markets' regulators to answer: First, have these opaque, complex, increasingly sophisticated trading mechanisms been beneficial for retail investors, helping them to buy at the lowest possible price and sell at the highest price with the lowest possible transaction costs? Or have they left them as second-class investors, pushed aside by powerful trading companies able to take advantage of small, but statistically and financially significant, advantages?

And second, do these high-tech practices and their ballooning daily volumes pose a systemic risk? To take just one example, is anyone examining the leverage these traders use in committing their capital in such huge daily volumes? What do we really know about the cumulative effect of all these changes on the stability of our capital markets?

The proponents of these technological developments tell us that this transformation has benefitted all investors.

But how can we know that when so much of the market is opaque to the public and to the regulators?

How can we be confident when the measurement and enforcement techniques used by regulators for ensuring best execution seem stuck in the past, and when so many trade in milliseconds across fragmented markets to take advantage of so-called market "latencies"?

And why should we assume that it all operates in the public interest when these changes have not been fully analyzed, individually or collectively, to determine and protect the interests of long-term investors?

That is why on August 21, I wrote to SEC Chairman Mary Schapiro, calling for “a comprehensive, independent ‘zero-based regulatory review’ of a broad range of market structure issues, analyzing the current market structure from the ground up before piecemeal changes built on the current structure increase the potential for execution unfairness.” I told her then that “we need a thorough review...so that our laws and regulations can keep pace with market developments.”

In her written response to me on September 10, Chairman Schapiro announced that not only was the SEC reviewing dark pools and flash orders, studies that it had begun earlier this year, but that it would broaden its review to include Regulation ATS threshold levels, direct market access, high-frequency trading, and co-location.

Adding action to those words, last week the SEC unanimously approved a proposal to ban the use of flash orders in our financial markets. Flash orders undermine the credibility of our markets by giving a select group of market participants a sneak peak at stock quotes. As Chairman Schapiro noted, “flash orders provide a momentary head start in the trading arena that can produce inequities in the market.”

I applaud the SEC for its action. The proposal must be put out for public comment, which the SEC will review before making a final decision.

I’m hopeful that last week’s action was a true beginning. Banning flash orders is only a small — though significant — step in the review of recent market developments.

Accordingly, I was very pleased last week to hear the Chairman, Commissioners, and the SEC staff voice their support not just for the flash order ban, but also the need for a comprehensive, ground-up review at the Commission of current market structure issues.

Chairman Schapiro last Thursday asserted that “other market practices may have...opaque features” and that she expects the Commission to “consider initiatives in the near future” that address “forms of dark trading that lack market transparency.”

James Brigagliano, Co-Acting Director, Division of Trading and Markets, added: “I want to emphasize that today’s recommended proposal is a first step in an ongoing review of market structure issues. The securities markets have experienced extraordinary changes over the last few years in trading technology and practices. Some of these changes have led to serious concerns about whether the regulatory structure remains up-to-date. The division is examining a wide range of market structure issues including certain practices with respect to undisplayed or ‘dark trading interests’ in addition to flash orders that are the subject of today’s proposal. We anticipate making additional recommendations to the Commission in the coming months for proposals to address discreet issues, such as flash orders, that warrant prompt attention. There is

also a spectrum of broader market structure issues and practices that affect the interests of investors and need to be examined closely.”

Mr. President, I am pleased to hear the Commission is taking this review seriously.

And I say bravo to the SEC. The agency tasked with upholding the integrity of our markets should actively review the rapid technological developments of the past few years, and analyze their costs and benefits to long-term investors.

Eugene Ludwig, former Comptroller of the Currency, recently reminded us that each of the financial crises of the past 25 years — the collapse of the savings and loan industry, the Internet-stock bust a decade later and last year's credit-market meltdown — was the result of inadequate regulation.

Another former regulator, Brooksley Born, a former Chairman of the CFTC, warned us of the opaqueness of the derivatives markets at a time when they were becoming big enough to cause trouble. Earlier this year, she recalled her warnings: “I was very concerned about the dark nature of these markets.” And further, “I didn’t think we knew enough about them. I was concerned about the lack of transparency and the lack of any tools for enforcement and the lack of prohibitions against fraud and manipulation.”

History proved Brooksley Born was right – unchecked, unexamined innovation severely weakened our markets and ultimately led to disaster.

Sometimes small, apparently technical innovations in our vast and complicated financial system can generate great benefits for all – and other times they can generate disastrous unintended consequences.

It is also fair to say that well-intentioned regulation in a complex market can also have unintended consequences.

That is why we need regulators on the job, undertaking a thoughtful and reasoned analysis, so we can have a clear view of where innovations may be taking us and whether wise regulations can help curb abuses.

Regulators simply must keep pace with the latest market developments. And we in Congress must give regulators the tools they need to observe and stay abreast of the sophisticated financial players they are charged with regulating.

Three examples from the current debate are especially illustrative of this need: co-location of servers at the exchanges, flash orders, and direct market access.

When the exchanges first began to permit traders to place their computers on-site, giving these traders a few micro-seconds advantage, the SEC did not insist on regulatory approval. The Commission simply let it occur. There was no active consideration then, as I have called for now, of the means by which “fair access” can be preserved.

The same is true for flash orders. In May, the SEC staff permitted Nasdaq and BATS Exchanges to introduce flash-order offerings even though both admitted that the practice was of dubious value and that they simply were being driven to adopt it by the loss of market share to competitors. Both exchanges later reversed those decisions voluntarily, which is commendable, but let us not forget that this was a telling example of rote piecemeal review by the SEC staff applying outdated floor-based precedents to electronic-age developments.

Direct market access is another practice that deserves closer examination. Such agreements allow high-frequency traders to use their broker's market participant identification to interact directly with market centers. In order to maximize speed of execution, many sponsored access participants may neglect important pre-trade credit and compliance checks that ensure faulty algorithms cannot send out erroneous trades.

According to John Jacobs, chief operations officer at Lime Brokerage, this risk is quite significant: "At 1,000 shares per order and an average price of \$20 per share, \$2.4 billion of improper trades could be executed in this short time frame...The next Long Term Capital meltdown would happen in a five-minute time period."

When did direct market access begin, and has the SEC ever considered its ramifications from a comprehensive standpoint?

Some are now saying that co-location and flash orders are very old fashioned concepts, and perhaps co-location for its part will ultimately be practiced better in the automated environment than it had been on the floors. I'm sure some old hands can tell hair-raising stories about the old days and floor space out of the Chicago pits.

But that is the point: co-location and flash are two of many transformational changes this decade that have been considered piecemeal and only in the context of existing policies.

Like direct access, these changes may have been found equal, or even superior, to their floor-based antecedents. But, in an automated age, these changes need to be subjected to a holistic analysis of their collective impact on the markets and our regulatory infrastructure.

The same is true for high frequency trading, dark pools, payment for order flow, liquidity rebates, and other market structure issues. The rapid rise of high-frequency trading and dark execution venues has quite simply left our regulatory agencies playing catch up. High-frequency traders can execute over one thousand trades in a single second. According to the TABB Group, these traders are now responsible for over 70% of all daily US equity trades. 70 percent!

And we're learning more about high-frequency trading every day. According to one industry expert, "most high frequency shops have huge volumes but few transactions, about 95 to 97% of trades are orders sent and canceled."

What does all this mean for the long-term investor?

Trading is not only faster, it is also quickly becoming less transparent. Twelve percent of trades are now conducted in dark pools, compared to less than 1% six years ago. And substantial percentages of trades are internalized at broker-dealers, never reaching a public exchange.

Maybe in the old days there were block trades happening in the dark, too. But many commentators have raised concerns about whether the darkening trends today truly threaten to undermine public price discovery.

The strength of a free market is in its public display of price quotes to all market participants.

These recent developments quite simply need to be better understood.

Yet still, after all the disasters, the billions of dollars lost, the homes foreclosed, the jobs lost — after all the pain that has been caused across this country — some on Wall Street reject even the notion of regulatory scrutiny.

They become defensive about the “politicization” of the process when Congress asks basic questions.

They say that Congress and the media can never understand high-frequency trading. They point to the benefits of high-frequency trading – narrowed spreads, added liquidity, and faster executions – and ask everyone to trust that there will be no side effects, no unintended consequences.

Some still argue that the market operates best without any regulation, that changes in market structure are the natural consequence of innovation and competition, and that there is nothing good to be gained from regulators or Congress studying possible sources of inequity.

To their credit, not everyone on Wall Street has reacted this way, Mr. President. Others have said that now is the right time for a comprehensive review of market structure developments.

These Wall Street leaders acknowledge that there are indeed many valid questions being raised about dark pools, payment for order flow, other market innovations, and the measurement and enforcement of best execution.

Indeed, some high-frequency traders have said they welcome a regulatory examination of high-frequency trading, because they are confident that high-frequency trading will pass the test with flying colors.

That is the correct attitude. We need a regulatory review with Wall Street’s cooperation.

It is in the nature of our financial markets to push the envelope, to take on more and more risk, and to exploit any crack in the wall when there are profits to be won. But to have a full

accounting, we also need to add up the costs to the long-term investor, to financial stability, to innocent bystanders, of each new generation of innovation.

In years past, without a sufficient regulatory presence, an aura of invincibility developed at many financial institutions.

We failed to ask questions, we failed to ensure that regulators were on the field with the tools they need to do their jobs, and the results are clear: millions of Americans have lost their jobs, their homes, and their savings.

We must not repeat that mistake.

It is time for Congress and the regulators to ask questions and for Wall Street to step forward responsibly and answer them – with the data to back up those answers.

We cannot simply react to problems after they have occurred. We need the information and resources to identify problems before they arise and stop them in their tracks.

Our goal is not to stop high-frequency trading. We don't want to slow it down.

Liquidity, innovation, and competition are critical components of our financial markets.

But we cannot allow liquidity to trump fairness, and we cannot permit the need for speed to blind us to the potentially devastating risks inherent in effectively unregulated transactions.

We cannot forget that fair and transparent markets are cornerstones of our American system.

As I have said before, fairness in the financial markets may be an elusive and ever-evolving concept. But it must be defined and then vigorously defended by the regulators.

The credibility of the markets and investor confidence simply demand that regulators be ever-watchful, sophisticated and tough against those who would breach the rules.

Mr. President, I am not demanding an immediate, wide-ranging regulatory overhaul.

I will not place symbolic action over prudent investigation — that would be impulsive and irresponsible.

But, given the lessons of the past, I will not allow potentially risky market practices to go unexamined. I will ask questions and strive to improve my understanding of these opaque market practices and, if necessary, push appropriate reforms. I am very pleased the SEC has agreed to do the same.

Mr. President, if we fail to learn from past mistakes, we can be sure that history will repeat itself.